ANNEX C

A Brief Overview of Mortgage Insurance

in Other Countries

Prepared by

Roger F. Blood

Prepared for

USAID

March, 1998

A BRIEF OVERVIEW OF MORTGAGE INSURANCE PRODUCTS IN OTHER DEVELOPED COUNTRIES

INTRODUCTION

This brief overview is designed to supplement the February 1998 report entitled "The Role of Insurance in Home Mortgage Finance in the United States" recently submitted to USAID and the Polish Banks Association. This supplement focuses upon mortgage insurance programs in several other developed housing finance sectors outside the United States, including Canada, Australia and New Zealand, the United Kingdom, France, and Sweden. While a greater number of countries, including some lesser developed economies, have various forms of mortgage guarantees provided by a government agency, guaranteed mortgages as a bona fide insurance product are found in very few countries.

CANADA

Unlike in the U.S., where there are hundreds of sizeable mortgage lenders, mortgage lending in Canada is dominated by only about a half dozen large banks and trust companies. Most home loans remain in the portfolio of the originating lender; currently a very low percentage of total loans made are sold into the secondary mortgage market or securitized.

Under national banking regulations, all home mortgage loans over 75 percent loan-to-value ratio in Canada must carry mortgage insurance. Qualified MI coverage may be provided to originating banks either by the government housing finance agency or by a private insurance company.

Government sponsored mortgage insurance, which traditionally has dominated the Canadian mortgage market, has been provided by an agency of the central government (CMHC) on new housing since the 1950s and on existing housing since the 1960s. This program offers 100 percent coverage of individual loans, with down payments as low as five percent of the purchase price.

Mortgage insurance premiums are all prepaid at the loan closing in contrast to the U.S. where MI premiums are paid annually and, increasingly monthly over the life of the insured loan. Premiums vary by loan-to-value ratio. Mortgage insurance is provided for home purchase loans and refinances, owner- and renter-occupied property, and first and second mortgages. Home construction loan guarantees, which are prohibited in the U.S., are offered for an additional premium charge.

Several privately capitalized mortgage insurance firms operated in Canada during the 1970s and 1980s. However, the dominant government mortgage insurer possessed various market advantages, including the ability to assume more marginal risks and avoid adverse risk selection, which made it difficult for private insurers to compete effectively. In 1996, the last domestic Canadian mortgage insurer ceased doing business. GE Capital Corporation, a leading U.S.-based MI parent company, recently re-started the private insurance business in Canada. This new program, similarly to previous private programs, closely resembles the government program in terms of coverage features and premium pricing, it remains to be seen whether private sector insurance will succeed in the face of advantaged government competition.

A mortgage insurance company operating in Canada is subject to national regulations governing all property and casualty insurers, and, in addition, certain special regulations apply only to mortgage guaranty insurance, which is classified as a special form of property and casualty insurance.

As a separately classified line, mortgage insurance in Canada is, de facto, regulated as a monoline business, similarly to its U.S. counterparts. While the regulation itself contains no further restrictions as to the type of properties or mortgages that may be covered, the insurance regulator requires a comprehensive business plan as a prerequisite to granting an insurance charter; such a plan normally would stipulate the intended program scope, e.g. residential mortgages up to 95 percent LTV. Any insuring activities outside the scope of the business plan would require further regulatory approval.

A Canadian mortgage insurer also is subject to a special form of long term contingency reserve for future depression level losses. Whereas in the U.S. and Australia the required contingency reserve is a function of annual earned premium (50 and 25 percent respectively), in Canada the "added policy reserve" is calculated as a function of the unearned premium reserve for each book of business. That is, the amount of the reserve varies with the age of the book between the third and 19th year of the standard 20-year term policy.

As in the U.S. and elsewhere, the special regulation governing unearned premiums over the policy life stipulates a series of factors designed to track approximately the historic average "claims development curve" over the insured loan term.

"Case basis" and "IBNR" reserves for defaulted mortgages are required under the general insurance regulation. "Case basis" reserves require the mortgage insurer to establish as a liability a loss reserve account, the amount of which is explicitly related to those insured loans that have fallen into arrears by three or more months. These loss reserves are established mainly on the basis of notices of default received from insured lenders. However an additional "IBNR" ("Incurred but Not Reported") reserve component must also be established using experience- based estimates of insured loans that have fallen in arrears, but have not yet been reported to the insurer. Case basis reserve requirements for mortgage insurers, while less specific than in the U.S., do require incremental provision for "adverse development".

Unlike in the U.S. the Canadian mortgage insurer is no subject to specific regulatory requirements relating to geographic or other types of risk concentration. Rather, general standards of risk management applicable to all casualty insurers apply.

Through a combination of insurance and banking regulation restrictions, mortgage lenders in Canada may not collect a commission or other compensation for placing coverage with a mortgage insurer. Whereas in the U.S., such restrictions are specifically targeted to mortgage guaranty insurance, in Canada the prohibition against banks acting as commissioned insurance agents appears to extend far more broadly.

Regarding investments, the Canadian insurer may not hold real estate and/or mortgages amounting to greater than 10 percent of admitted assets. However, properties acquired as results of claims settlements fall outside this restriction. Such is not the case in the U.S.

In turn, special and more restrictive capital requirements apply to mortgage insurance than to other property and casualty lines in Canada. Applicable risk-based capital requirements operate on sliding scales according to both loan-to-value ratio and percent of coverage placed on the individual loan. For the benchmark 90 percent LTV, 100 percent coverage policy, required capital equals 1.08 percent of the total insured loan amount.

Related lines. Regarding title-related risks, the standard means of certifying title in Canada is via the lawyer's opinion. Several title insurers have recently entered the Canadian market, and this product may have a greater role in the future as registries automate. However, with title insurance demand tending to arise more from the secondary than the primary mortgage market, this type of insurance has not been significant in Canada as it has been in the U.S.

Homeowners hazard insurance is routinely required to be maintained on mortgaged homes, with the secured lender named as a beneficiary on the policy.

Mortgage life insurance is commonly offered to home purchasers by the originating bank at the time of purchase, with the lender acting as a commissioned agent. Disability insurance is available, but less frequently taken at the point of home purchase.

Errors and omissions insurance designed especially for mortgage lenders and servicers is not found in Canada as it is in the U.S. because the practice of originating and servicing large mortgage portfolios for third party investors is not prevalent. Likewise, special hazard (e.g. flood and earthquake) insurance is not offered in support of the home mortgage business.

Professional liability insurance is available in Canada to cover, for example, the actions of attorneys who close mortgage loans.

AUSTRALIA AND NEW ZEALAND

Mortgage insurance has been available to lenders in Australia and New Zealand for over thirty years. Three private companies have dominated the market. In Australia, a government sponsored mortgage insurer has also accounted for nearly half the market over recent years. That insurer, however, was privatized in 1997, having been sold to the U.S.-based GE Capital Corporation. In addition, several state governments in Australia guarantee mortgage-backed bonds, though the underlying loans are covered, as required, by mortgage insurance.

As in the U.S. Australian/New Zealand mortgage insurance companies are monoline, i.e., under their charter they underwrite only risks associated with mortgage default. Whereas the active U.S. insurers write first mortgages on 1-to-4 family residences, the Australia-based mortgage insurance companies also guarantee mortgages secured by commercial properties. The three private mortgage insurance firms serving Australia and New Zealand Commercial Union, Sun Alliance, and MGICAare qualified as investment grade by major rating agencies such as Moody's and Standard & Poor's.

Mortgage lending is highly concentrated among a small number of banks operating throughout each country, although a significant and growing share of loans are new securitized and sold. Mortgage loans are made up to 95 percent loan-to-value, and loans over 75 to 80 percent loan-to-value ratio typically are insured. Both 100 percent and partial coverage plans are offered. Premiums increase with the loan-to-value ratio. Although there are published premium rates, most business is done on a privately negotiated basis.

Mortgage insurance operates in a much more deregulated environment in New Zealand than in Australia. In New Zealand, mortgage insurance operates under rules applicable to general casualty lines. New business entry requires an initial capital deposit of only NZ$500,000, and there are no regulatory capital requirements based on outstanding risk.

Australia, while also regulating mortgage insurance as a general casualty line with minimum paid-in capital of $2 million, does impose some special requirements on companies writing mortgage insurance and other limited forms of financial guaranty including:

Minimum capital on individual insured loans where the insured loan balance exceeds 2/3 of the property's value. The capital requirement equals 2 percent of that excess amount, which means that higher loan-to-value ratios requires a higher effective reserve ratio.

An unearned premium reserve based upon the age of the loan and premium factors reflecting the general "claims development curve" over the term of the insured loan up to ten years.

A "claims equalization reserve" (comparable to the U.S. contingency reserve) equaling 25 percent of earned premium which must be retained for ten years unless required sooner under stipulated high loss conditions. As in the U.S. this provision tends to restrict entry, to restrict and defer dividend-paying capability, and to build a catastrophic loss reserve not found in other casualty lines.
Australian companies writing mortgage insurance under the above requirements are, effectively, monoline, even though there is no express monoline restriction in the regulation.

Other restrictions that are explicitly contained in U.S. insurance regulations governing mortgage insurance companies are more implicit in Australia. For example:

• No explicit geographic or other risk concentration limits apply. Instead, prudent risk management is the rule.

• A case basis reserve requirement applies to reported defaults (which, in the case of mortgage insurance is the "event of loss"), but without specific directives.

• Lender agency commissions or other forms of compensation for placing mortgage insurance is prohibited, but the applicable regulation is found in the consumer credit code, rather than in special regulations governing mortgage insurance. The provision in Australia applies only to the financing of owner-occupied housing.

• In Australia, the national insurance regulator ("ISC") exercises wider discretionary latitude as to "what makes sense" in terms of prudent insurance risk management, and what are the demonstrated capabilities of an existing insurance enterprise to extend the range of its underwriting.

The investment rating agencies (e.g. Moody's, Standard & Poor's, Duff & Phelps, Fitch) play a critical role as quasi-regulators of mortgage insurance firms arguably more effective than the government agency regulators. Insurance regulators in Australia and New Zealand, more than those in the U.S., appear to acknowledge the role of the independent private rating agencies in establishing effective safety and soundness standards for rated insurance firms.

Related lines. Regarding title-related risks, Australia and New Zealand operate under a "Torrens" system of land and deed registration, so there is no need for title insurance. A land registry certificate is effectively a guaranty of title. The solicitor (attorney) performs the title search at the registry. These solicitors must belong to the bank's panel of qualified professional service providers; as such, they are covered by a professional indemnity bond.

As in most developed mortgage markets, homeowners hazard insurance must be carried as a condition of receiving mortgage financing. As in the U.S. mortgage lenders carry special backup hazard insurance in the event that the homeowner's individual coverage is permitted to lapse.

Mortgage loan securitizers have sought to secure protection against the risk that a mortgage lien might be determined to be unenforceable. Such a risk typically is excluded by a mortgage insurance firm, which requires perfection of the lien before honoring a claim for loss. Such protection has been provided by at least one mortgage insurer in Australia/New Zealand, with the risk then being reinsured through an errors and omissions carrier.

Standard errors and omissions coverage and special fidelity bonds protecting against employee fraud, such as is routinely carried by U.S. mortgage originators and servicers, is not available to Australian/New Zealand mortgage lenders. Professional indemnity and directors and officers liability insurance are commonly used by banks active in the mortgage business.

Banks offer homebuyers mortgage life and (to a lesser extent) disability insurance for which the bank operates as a commissioned agent. The lender is not permitted to require such insurance as a condition of granting the mortgage loan.

For the Australian equivalent of condominium properties, the mortgage lender requires that "body corporate" insurance coverage on the entire multifamily building be maintained by the owners' association during the life of the mortgage.

THE UNITED KINGDOM

Mortgage insurance providers in the U.K. differ significantly from their counterparts in the U.S., Canada, and Australia and New Zealand. The half dozen mortgage insurers that dominate the U.K. market are not monoline, but rather are integral parts of large general multiline insurance carriers, such as Royal, Sun Alliance, Commercial Union, and General Accident. The strict and specialized regulatory environment under which U.S. mortgage insurers operate is virtually absent in the U.K.

Mortgage insurers provide cover mainly for about 20 U.K. building societies, which are deposit institutions that specialize in making home mortgage loans. These lenders typically insure all loans made over 75 or 80 percent loan-to-value ratio. Maximum loan-to-value ratios, previously 100 percent, have been reduced to 95 percent. Premium rates vary with the loan-to-value ratio and, unlike the U.S., are prepaid.

Following a period of severe claims losses in the early 1990's, the U.K. mortgage insurers instituted greater restrictions on the share of total risk exposure they would accept on individual high LTV ratio loans.

When mortgage insurance is written by a U.K. lender, it is typically part of a larger package of coverages offered by the lender, with the lender receiving an agency commission on each line. Such coverages would include not only housing related lines, such as homeowners and mortgage life, but also automobile liability coverage. Combined insurance agency commissions constitute a significant share of home mortgage-related income for originating lenders in the U.K.

Unlike the U.S., Canada and Australia/New Zealand, carriers do not file separate mortgage insurance financial reports or statistics with regulators. Although the MI product is not monoline, mortgage insurance reserves are segregated.

Insurance regulation in the U.K. relies heavily on disclosure to policyholders and general solvency regulations, rather than on stipulating specific business and financial practices, as is prevalent under U.S. insurance regulations, including those governing mortgage insurers. For example, the U.K. imposes no specific "risk-based capital", unearned premium, or other special reserving formulae upon mortgage insurers. Application of these types of standards are left to the private market, including the private rating agencies.

Related lines. Title insurance is not normally used on home mortgage loans in the U.K. Lenders (and therefore mortgage insurers) rely on the attorney's opinion of title. As in other countries, homeowners hazard insurance typically is required on mortgaged properties. In the U.K., the building societies who originate most home mortgages are especially active in selling such personal lines to borrowers on a commissioned basis.

FRANCE

France has a widely used credit enhancement product relating to home mortgage lending that is quite different from mortgage insurance in other developed countries as discussed above.
A subsidiary of Credit Foncier called Credit Logement provides France's mortgage lenders with an unusual form of credit insurance on mortgage-related loans. (While both Credit Foncier and Credit Logement are both predominantly public sector-owned enterprises, there is now underway an active effort to privatize them.) Three major French banks hold most of the minority interest in Credit Foncier and Credit Logement.

For payment of a one-time premium of about two percent of the insured loan amount, Credit Logement will insure the loan against 100 percent of any default-related losses. However, at the time the loan is insured, it is not registered as a first mortgage. In fact, the insurance is used as an alternative to recording the newly closed loan as a registered lien, which in France is a costly and time-consuming process. Credit Logement's ability to enable borrowers to avoid transaction-related costs, fees and taxes results in home loan financing being carried out at substantially lower costs, which helps to explain why the market is willing to pay for this service.

Part of the purpose of using this insurance service is to protect against the incremental risks of not having a registered lien. Instead, if and when the insured loan goes into default, Credit Logement as insurer may attempt to register and enforce the lien as part of the recovery effort and as an alternative to successful recovery directly from the borrower. In effect, Credit Logement covers against both default and title-related risks.

Credit Logement reportedly underwrites individual loans to fairly high standards and, accordingly, has experienced a relatively low incidence of claims. Loan-to-value ratios range up to 90 percent, and certain home improvement loans may also be covered.

Properly speaking, Credit Logement is not in the business of insurance. Its capitalization, which nominally is required be 8 percent of outstanding risk exposure, is rather complex. Essentially, the capital structure is designed to conform to the international risk-based capital rules applicable to banks under the Basle Accord. Functionally speaking, Credit Logement serves more as an administrator of a risk-based loss reserve fund than as a risk-assuming insurance entity. For the services it provides, Credit Logement receives 20 percent of premium received plus investment income generated by the Mutual Guarantee Fund.

Core capital, amounting to less than one percent, comes from paid-in capital stock and retained earnings. A "mutual guarantee fund", amounting to an additional two percent of risk outstanding, consists of premiums received and held in reserve. The "mutual" feature refers to a provision similar to that of the public sector mortgage insurer in the U.S, namely that borrowers who eventually pay off their loans in full are entitled to receive a significant share of their premium back (without interest).

Finally, and perhaps most significantly, banks benefit and have incentive to secure Credit Logement coverage on their home loans because they receive a significant reduction in their risk-based capital requirements for doing so. In short, home loans in France that are registered as mortgages are assigned a 50 percent risk-based capital weighting (4 percent), whereas comparable unregistered loans covered by Credit Logement only carry a 20 percent risk-based capital requirement (1.6 percent). Unlike in the U.S. this risk-based capital benefit is unrelated to any specific loan-to-value ratio threshold.

SWEDEN

Unlike the other countries discussed above, mortgage insurance in Sweden is provided only by an agency of the national governmentùthe Swedish National Housing Credit Guaranty Board (BKN)ùand not by private insurance companies.

Home mortgage lending in Sweden is concentrated among fewer than ten housing oriented mortgage institutions, the majority of which are bank-owned. Mortgage loans typically are made up to 75 percent LTV ratio. While the loans, including those that are BKN-guaranteed, are held in portfolio, these mortgage portfolios typically are financed by mortgage bonds sold both to institutional and individual investors.

The BKN housing credit guaranty system is largely automated. As in the U.K., participating lending institutions report to BKN loans made which will carry a guaranty and, in the event of a claim, the lender must be able to show that the defaulted loan had been originated under the established parameters of the guaranty program.

Although the national government provides the ultimate backup for mortgage guaranties issued by the BKN, the program is designed to operated on an actuarially sound basis. This type of program structure resembles that of the national mortgage insurance program sponsored by the U.S. government.

The BKN guaranty program covers mainly new construction, but also includes rehabilitation of existing housing. While a major share of activity involves cooperative multifamily housing, rental and owner-occupied housing are also eligible for coverage. The amount of the individual loan guarantee is less than 100 percent and is established as a designated percentage of an "approved guarantee value". As with MI programs in all other countries discussed, components of coverage include loan principal, interest in arrears, and foreclosure-related costs, all subject to established policy limits.
Early experience reported by BKN suggests that mortgage insurance risks are greater on rental housing than on cooperative housing, and, in turn, that cooperative housing loan risks are generally greater than risks associated with mortgages on owner-occupied properties. Such patterns would be consistent with that experience in the U.S.

Note: The above summary is based upon information provided by the Swedish National Housing Finance Corporation (SBAB).

SUMMARY

A small number of countries support housing through mortgage insurance programs that are self-supporting, actuarially sound, and in the case of private firms, profitable. Mortgage insurance in some countries is provided by both public and privately capitalized entities, in which instances the issue of maintaining a "level competitive playing field" inevitably seems to arise.

Despite wide differences in the regulatory environment, important common (though not universal) practices are found among private mortgage insurance firms in developed economies, including: (1) special risk-based and catastrophic reserving arrangements; (2) restrictions on agency commissions and other financial inducements for originating lenders; (3) premium rates variable by loan-to-value ratio; (4) monoline operations; (5) dependence on reasonably reliable title registry and foreclosure systems; (6) exclusion/separation of property/casualty and title-related risks; and (7) an effort to avoid of "adverse selection of risk", particularly through lending requirements that all loans exceeding a certain loan-to-value ratio must carry mortgage insurance.

Mortgage insurance exhibits several common fundamental characteristics which cut across international boundaries: (1) the insured risk covers both random individual events and economic adversity, both regional and national; (2) both the exposure period and the loss cycle are unusually long compared to other insurance lines; (3) mortgage insurance business volume and risk performance are more affected by national economic policies than are other insurance lines.

These key distinctions between mortgage insurance and other insurance lines mean that the regulatory provisions and analytic approaches needed to assure long term strength and solvency need also to be distinct from other insurance lines.